A 21 standard deviation wake-up call

By Jan Dehn

The Brexit shock was a 21 standard deviation event in GBPUSD. It is time to ditch the fiction of risk-free developed markets. EM asset prices behaved well in response to the Brexit shock and offer potentially better risk-return characteristics. We believe that investors should accept the facts and reduce their remaining exposure to developed markets. In Colombia, the government and FARC rebels agree to stop fighting each other. China is gradually and deliberately allowing more corporates to go to the wall, but default rates remain very low. Brazil's acting president strikes an important deal with States that increases the odds of meaningful fiscal reform and in Venezuela relations with the US thaw.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	0.14%
MSCI EM Small Cap	11.1	–	-1.50%
MSCI Frontier	9.1	–	-5.77%
MSCI Asia	11.3	–	-0.31%
Shanghai Composite	11.7	–	-0.73%
Hong Kong Hang Seng	6.6	–	1.46%
MSCI EMEA	9.6	–	1.12%
MSCI Latam	12.3	–	1.60%
GBI-EM-GD	6.48%	–	0.47%
ELMI+	4.23%	–	-0.09%
EM FX spot	–	–	0.23%
EMBI GD	5.60%	400 bps	0.57%
EMBI GD IG	4.23%	256 bps	0.33%
EMBI GD HY	7.49%	601 bps	0.83%
CEMBI BD	5.44%	402 bps	0.26%
CEMBI BD IG	4.16%	274 bps	0.25%
CEMBI BD Non-IG	7.59%	615 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.3	–	-1.62%
1-3yr UST	0.59%	–	0.17%
3-5yr UST	1.03%	–	0.27%
7-10yr UST	1.52%	–	0.52%
10yr+ UST	2.38%	–	0.17%
10yr+ Germany	-0.08%	–	1.17%
10yr+ Japan	-0.19%	–	1.19%
US HY	7.25%	587 bps	0.53%
European HY	5.15%	562 bps	-0.76%
Barclays Ag	–	238 bps	0.04%
VIX Index*	25.76	–	6.35%
DXY Index*	96.02	–	2.40%
EURUSD	1.1061	–	-2.24%
USDJPY	102.14	–	-1.73%
CRY Index*	188.69	–	-3.69%
Brent	48.7	–	-3.77%
Gold spot	1325	–	2.73%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

The spill-over into Emerging Markets (EM) asset prices from the UK Brexit shock referendum vote was relatively minor. EM credit traded well in light of the magnitude of the event: CDS spreads initially spiked, but since retraced half their initial move and bond prices ended the day just half a point lower on Friday (in the EMBI GD index). This compares to the move in senior IG CDS (iTtraxx) of 25 bps and constituted a large out-performance versus the iTraxx cross-over index, which widened 75bps. EM currencies and bonds weakened, including central European currencies like the Zloty, but moves were modest.

EM economies have very limited direct trade exposure to the UK, although they could be impacted by a broader global growth shock, which we do not expect. The fact that the impact on EM fundamentals is likely to be even smaller than the impact on asset prices means that investors can make money by buying into any temporary weakness. Indeed, we expect EM to outperform developed markets for a number of reasons.

- **EM technicals are good.** Positioning is not at all crowded, because investors have broadly favoured developed market assets over EM assets since the Taper Tantrum of 2013.
- **Absolute valuations in EM are attractive.** As recently as February of this year the average bond in EM paid a higher absolute yield when the Fed has rates above 5%. By contrast, developed market bonds pay negative yields in the main.
- **EM fundamentals are robust.** EM net external balances are improving sharply thanks to competitive real exchange rates. EM countries are generally growing faster, have lower debts, better demographics, room to adjust policy and they are less dependent on global capital and hence more isolated from the DM political crisis.
- **EM Central Banks have more room to act.** Indonesia, India, Brazil, Argentina, South Korea, Russia, Taiwan, Singapore and China all have in common that they have room to cut interest rates in the future thanks to previous positive policy actions and low inflation. EM CB reserves are at high levels and swap lines would be readily available if needed. Many countries are well positioned to stimulate fiscally, if needed.

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Emerging Markets

The situation is quite different in many developed economies, where nationalism and populism are now very evidently on the rise. Indeed, political developments in Europe and the US look eerily similar to the aftermath of the Great Depression, where the mainstream gave way to populists and then eventually cross-border conflict. The underlying causes are unresolved economic issues that fester and create voter disaffection. Mainstream politicians are jettisoned in favour of populists, but the populists have no answers either so eventually democracy itself is called into question. We are not quite at that point yet, but the direction of travel is clear enough.

As if to underline this point, last week the International Monetary Fund cut its forecast for U.S. growth to 2.2% this year, down from 2.4% in its April 2016 World Economic Outlook. The IMF cited headwinds including the strong dollar and weak investment as well as a lower potential growth rate and a smaller output gap than previously estimated. As for the UK, it seems clear that the UK economy will now enter a slump. All investment decisions involving links to the EU will be postponed, possibly for years until the UK's new relationship with the EU is clarified. Also, given the chaos unleashed within the main political parties in the UK all investment which depends on government spending is likely to be postponed. And finally, investments that are sensitive to the economic cycle are likely to be postponed as well as FDI flows from outside the EU pending further clarity about the UK's future.

As usual, the only backstop left is monetary support. Fed Chairwoman Janet Yellen thus issued a dovish message in her testimony to Congress last week, highlighting "considerable uncertainty" in the outlook. The probability of any rate hike between now and January 2017 is now priced at just 17%. In this environment, the market will take some comfort from the German Constitutional Court's rejection of challenges to ECB's Outright Monetary Transactions (OMT) programme.

The big winners from the UK Brexit vote are likely to be nationalists across the rest of the developed world. Last week both France's Marine Le Pen and Italy's 5-Star movement issued demands for referenda on EU membership. The rise of Shinzo Abe in Japan and Donald Trump in the US are also part of the same trend of rising nationalism that led to Brexit in the UK. In Europe, of course, it is worth recalling that EU's institutions were designed to protect against the very tribalistic forces that are now on the rise across the continent, so stakes are higher. In light of these trends, the shift back towards the centre in Spain's election at the weekend offers some solace, but probably only temporarily. Europe is clearly at a pivotal moment in its history, a moment where it must decide if it wishes to revert to the divisions of old or renew efforts to unify.

Given that the underlying problems are far from being resolved, it is likely that developed markets will continue to be a source of instability for global markets. Investors really ought to ask themselves if it is appropriate to continue to be heavily invested in such countries. In EM, volatility is generally expected, but in most developed economies risks are sometimes not even perceived, let alone priced. The -11.75% intraday move in GBP on Friday was a 21-standard deviation event. It is time that investors wake up to the fact that developed markets are far from risk free and that investors are simply not paid adequately. For example, between 2000 and the end of May 2016 European IG government bonds had twice the volatility of Euro-denominated EM IG government bonds, yet paid investors only half the yield. It is also illustrative that Moody's only moved the UK outlook to negative from stable after the Brexit event and that the ratings agency still has the UK sovereign credit rating at Aa1. This despite the fact that the country's main political parties are falling apart and that the entire nation is at risk of disintegration as Scotland and Northern Ireland now consider their futures within the union.

We strongly recommend that investors face up to these facts and significantly reduce their exposure to developed markets. Risks are simply not priced and investors are not being adequately compensated. The uncertainty – economic and political – will clearly continue in the UK and other developed economies. Switching to EM IG euro- denominated bonds achieves better returns and lower volatility than European government bonds, while at the same time reducing exposure to events in Europe, because the correlation between European and EM IG euro-denominated bonds is less than 50%.

- Colombia: FARC rebels and the government announced a bilateral ceasefire following broad agreement on the terms of a permanent peace agreement. The deal, which will likely have to be approved in a referendum, constitutes a major political victory for President Juan Manuel Santos, for the FARC and for Colombia. Colombia has come a very long way from the dark days in the 1980s, when the state was on the brink of collapse at the hands of drug lords, left-wing rebels and right-wing paramilitaries. Colombia's achievement cannot be underestimated and may yet see Santos, the most gifted politician of his generation, receive the Noble Peace Prize. In addition to the humanitarian importance of a permanent peace deal with the FARC, the peace accord will also free up room for the government to refocus attention on economic issues. Fortunately, the economy is now slowly responding to gentle prodding by the government. The Central Bank hiked interest rates by another 25bps to 7.5% last week and the current account deficit finally showed signs of shrinking significantly. The deficit narrowed to just USD 3.38bn, which is the smallest deficit since 4Q 2013 (equivalent to 5.6% of GDP, down from 6.4% of GDP for 2015 as a whole).

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• **China:** Chinese corporates are increasingly being allowed to default under the new regime of market determined interest rates. This is a quite deliberate development on the part of Chinese policy-makers as they gradually replace currency manipulation with interest rate management as the main instrument of macroeconomic control. The greater reliance on interest rate for macroeconomic control is one part of a three-pronged strategy to transform the economy from export-led growth to more balanced consumption-led growth. The other two parts of the strategy are productivity enhancement and capital account liberalisation. The good news is that China's bond market starts from a position of relative strength. New data from ICBC Standard Bank shows that only 0.1% of China's 25,255 bonds – a fixed income market with combined value of CNY 56,871bn, or USD 8.5trn – have defaulted. Within this total, there are 3,436 private corporate bonds with a total combined value of CNY 2,941bn (USD 443bn). These bonds currently have a default rate of 1.0% by number and 0.8% by value. Enterprise bonds, which are issued by state-owned enterprises, are a far bigger part of the fixed income market with 2,559 bonds valued at CNY 31,870 (USD 4.8trn). The default rate for enterprise bonds is 1.3% by number of bonds and 0.1% by value. To put these numbers in context, the US HY default rate is 5.77%, while the EM HY corporate default rate is currently 3.4%. In other news, the Monetary Authority of Singapore (MAS) announced last week that it will add CNY denominated securities to its official foreign reserves starting this month. Singapore has been investing in CNY denominated assets since 2012, but this is the first time that official FX reserves will also invest in local Chinese assets. Remarkably, the main index providers, all of which are Western investment banks – still do not include Chinese government bonds in their indices. This reluctance to include Chinese bonds is difficult to understand other than in terms of their own internal business considerations. Certainly, China's bonds are readily investable. Any investment manager wishing to trade China's markets can do so with relative ease. Finally, we note that industrial profits in China rose 3.7% yoy in May, a bit lower than in April (4.2% yoy).

• **Brazil:** Acting President Michel Temer has struck an important deal with Brazil's States last week, which significantly increases the odds that a pending fiscal reform and President Dilma Rousseff's impeachment will both go ahead. Under the deal, the central government extends debt relief to the States in exchange for which the states will encourage their MPs to vote in favour of Rousseff's impeachment and the fiscal reform designed by Finance Minister Henrique Meirellles. The debt relief offered to the States is already incorporated into the fiscal projections. In other good news, Brazil's current account surplus in May reached the highest level since 2007. The surplus was USD 1.2bn, which reduces the rolling 12-month current-account deficit to 1.8% of GDP from 2.1% of GDP in April 2016. The bulk of the current account surplus was due to a solid trade surplus of USD 6.3bn, which in turn was caused by rising exports of manufactured goods and lower imports. The services deficit also declined. FDI to Brazil was USD 6.1bn, which was stronger than expected (USD 5.9bn). FDI is now close to USD 80bn on a 12 months basis. The improvement in Brazil's external balances will have two effects of relevance to investors, namely to increase FX reserves and to generate faster GDP growth (since net exports enter directly and positively into GDP). Finally, inflation decelerated sharply to just 8.98% yoy in the first half of June compared to 9.10% yoy expected and 9.62% in the previous month. Receivers welcome!

• **Venezuela:** Relations between the US and Venezuela are thawing. This is a major shift in Venezuelan foreign policy, which until recently sought confrontation with the US during bouts of domestic trouble. US State Department Representative Thomas Shannon visited Venezuela last week. This was the first such visit for a long time and comes at a time when a leading Chavista dissident politician called for President Nicholas Maduro to be removed from office, while opposition politicians seek to build a case for a referendum to recall Maduro from office. Long queues have formed where people are called in to certify their original signature in favour of a recall referendum, and the bond market is performing strongly in anticipation of a post-Maduro administration. Oil Minister Eulogio del Pino re-iterated this week that the government will pay all its obligations.

• **Mexico:** Retail sales were up 10.6% yoy in April and employment in the retail sector rose 1.7% yoy. Real wages were also higher (2.9% yoy) in April. Headline inflation in the first half of June was just 0.02% mom, which was lower than the consensus expectation of 0.10%. Core inflation was 0.16% mom versus 0.14% expected. This means that core inflation is running at 2.98% yoy. Real GDP was up 3.0% yoy in April versus 1.2% yoy in March.

Snippets:

- **Argentina:** Another week, another rate cut. Banco Central de Republica Argentina last week cut the interest rate on its 35-day Lebac notes by 75bps to 31.5%.
- **Costa Rica:** A strong surge in exports of 8.6% to USD 4.26bn alongside a muted 2.5% increase in imports to USD 6.25bn underpinned a sharp narrowing in the trade deficit to just USD 1.99bn (3.5% of GDP) in January-May from USD 2.17bn (4.1% of GDP) over the same period in 2015.
- **Hungary:** Retail sales in April were 6.7% higher than a year ago. This constituted acceleration from the pace of retail sales in March (4.3% yoy). Hungary's current account surplus was also 26.6% higher in yoy terms in Q1 2016.

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- India: The government further eased regulations governing foreign direct investment into India's defence, civil aviation, single-brand retail and food sectors.
- Panama: FDI inflows reached USD 1.34bn (2.5% of GDP) in 1Q 2016 from USD 1.29bn (2.5% of GDP) in 1Q 2015. The current account deficit in Q1 2016 narrowed by a whopping 33.1% to just USD 530mn (1.0% of GDP) from USD 792mn (1.5% of GDP) in 1Q 2015.
- Peru: The surplus of the non-financial public sector declined to 0.5% of GDP in the period from January-May compared to 1.5% of GDP a year earlier.
- Russia: Industrial production accelerated to a pace of 0.7% yoy in May from 0.5% yoy in April, but retail sales softened and unemployment rose by 0.1% to 5.8%.
- Serbia: Fitch raised the sovereign credit rating for Serbia from B+ to BB- with a stable outlook.
- Singapore: Industrial production rose 0.9% yoy in May versus 1.0% yoy expected, while inflation declined 0.9% mom in May versus -0.7% yoy expected.
- South Africa: Inflation moderated to 6.1% yoy in May versus 6.4% yoy expected. Core inflation was 5.5% yoy. The High Court denied the National Prosecution Authority permission to appeal a ruling that the NPA made an error in dropping a corruption case against President Jacob Zuma.
- Taiwan: Industrial production significant beat expectations in May. IP rose at a rate of 1.9% yoy versus consensus expectations of -1.2% yoy. Export orders also surprised to the upside.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.23%	2.58%	-16.55%	-0.39%	-3.64%
MSCI EM Small Cap	-1.30%	-2.39%	-18.14%	0.12%	-2.29%
MSCI Frontier	-3.61%	-0.68%	-12.21%	0.61%	1.43%
MSCI Asia	-0.92%	-1.42%	-16.74%	3.02%	-0.01%
Shanghai Composite	-1.53%	-18.71%	-37.97%	16.16%	3.15%
Hong Kong Hang Seng	-0.08%	-9.71%	-35.14%	1.90%	-3.87%
MSCI EMEA	1.19%	9.30%	-16.18%	-4.32%	-6.62%
MSCI Latam	4.88%	18.24%	-14.38%	-7.72%	-10.24%
GBI EM GD	2.91%	10.82%	-1.67%	-3.69%	-2.52%
ELMI+	1.19%	4.43%	-2.86%	-3.18%	-2.88%
EM FX Spot	1.69%	3.46%	-8.98%	-10.05%	-9.20%
EMBI GD	1.78%	8.61%	7.59%	7.63%	6.25%
EMBI GD IG	1.68%	8.22%	6.10%	6.85%	5.30%
EMBI GD HY	1.90%	8.90%	9.38%	8.66%	7.60%
CEMBI BD	1.12%	7.09%	4.34%	5.97%	5.28%
CEMBI BD IG	1.13%	5.67%	4.57%	6.13%	5.40%
CEMBI BD Non-IG	1.10%	9.55%	3.60%	5.42%	5.09%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-2.71%	0.76%	-1.23%	11.31%	12.31%
1-3yr UST	0.59%	1.55%	1.52%	0.84%	0.71%
3-5yr UST	1.40%	3.52%	4.11%	2.81%	1.90%
7-10yr UST	2.54%	7.02%	9.26%	5.38%	5.08%
10yr+ UST	4.63%	13.22%	18.71%	10.61%	10.13%
10yr+ Germany	5.11%	15.96%	20.11%	12.96%	12.14%
10yr+ Japan	2.33%	15.98%	21.14%	10.78%	7.96%
US HY	0.74%	8.87%	0.76%	4.46%	5.92%
European HY	-1.19%	3.08%	1.25%	6.82%	8.88%
Barclays Ag	1.05%	5.71%	6.25%	5.27%	5.07%
VIX Index*	81.54%	41.46%	83.74%	52.79%	25.29%
DXY Index*	0.13%	-2.65%	0.57%	15.82%	27.36%
CRY Index*	1.36%	7.12%	-16.09%	-31.97%	-42.60%
EURUSD	-0.53%	1.89%	-1.56%	-15.17%	-22.58%
USDJPY	-7.75%	-14.93%	-16.65%	3.85%	26.27%
Brent	-1.91%	30.74%	-22.95%	-52.60%	-54.01%
Gold spot	9.05%	24.86%	12.33%	10.38%	-11.53%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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